

ANALYSIS OF ORIGINAL BILL

Author: Machado Analyst: Colin Stevens Bill Number: AB 2221

Related Bills: _____ Telephone: 845-3036 Introduced Date: 2-19-98

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Internet Service Provider Tiering or Filtering Software Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and Bank and the Corporation Tax Law (B&CTL), this bill would allow a credit to taxpayers who are Internet service providers (ISP) equal to the cost paid or incurred by the taxpayer for the purchase and installation of tiering or filtering software, as defined, that is placed on the ISP's web server.

EFFECTIVE DATE

This bill would take effect upon enactment and would apply to taxable or income years beginning on or after January 1, 1998.

BACKGROUND

The Internet contains a wide variety of information, and few rules limit the type of material that may be placed on it. Since an Internet search engine can locate sites dealing with sexually explicit material as easily as it can locate a newspaper article, anyone using the Internet has access to sites containing violence, sex or other material which may not be suitable for all age groups. As a result, many parents seek to limit their children's access to material by purchasing "filtering software," which blocks access to specified types of sites.

Filtering software is available in many ways. Individuals and businesses can download copies of filtering programs from companies' web sites, use online services that provide filters, or buy filtering software. Libraries or schools often buy or download more sophisticated software that runs on a computer server, allowing the computer network's administrator to distribute the program over all network computers. Many filtering software programs require online updates to identify new web sites that are to be blocked because new sites may appear daily.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE

____ GOVERNOR'S APPOINTMENT

Board Position:

____ S ____ O
____ SA ____ OUA
____ N ____ NP
____ NA ____ NAR
____ X ____ PENDING

Agency Secretary Position:

____ S ____ O
____ SA ____ OUA
____ N ____ NP
____ NA ____ NAR
DEFER TO _____

GOVERNOR'S OFFICE USE

Position Approved ____
Position Disapproved ____
Position Noted ____

Department Director Date
Gerald H. Goldberg 4/6/98

Agency Secretary Date

By: Date

SPECIFIC FINDINGS

Federal and state laws allow a variety of special tax credits and deductions designed to promote or influence specific taxpayer behavior believed to generate social or economic benefits for the general public. Included in state and federal law are tax incentives designed to promote business, such as credits for research and development, purchasing manufacturing equipment, the adoption of children, and providing child care facilities to employees. Neither state nor federal laws currently allow a tax credit for tiering or filtering software for Internet service providers. However, to the extent tiering or filtering software expenses are considered ordinary and necessary to conduct the taxpayer's business, these expenses would be allowed as a business expense deduction.

Existing state law provides general rules which apply to the division of credits among two or more taxpayers, a husband and wife, and partners. Unless specified, no tax credit may reduce regular tax below the tentative minimum tax (TMT) for alternative minimum tax (AMT) purposes.

Under the PITL and B&CTL, **this bill** would allow taxpayers who are an ISP a credit equal to the cost paid or incurred for the purchase and installation of tiering or filtering software.

The credit would be allowed over two years, with 50% of the costs allowed as a credit during the year in which the costs were paid or incurred and the remainder allowed for the immediately succeeding year.

This bill defines "tiering software" as any software or computer program placed on an ISP's web server that provides consumers with the opportunity to preselect based on user choice from one of several service content options provided by their chosen ISP.

This bill defines "filtering software" as the placement of software on any server that provides the ability to adjust, control, fine-tune, hone, filter any type of material or content, or scan for material or content that is in violation of sections of the Penal Code dealing with the distribution of pornography and child pornography, that can be viewed over the Internet.

This bill would provide that any unused credit may be carried forward for up to eight taxable or income years.

No credit would be allowed unless the taxpayer (ISP) provides the consumer with written notice of the use of tiering and filtering systems and provides the consumer with written notice that transfer or possession of material in violation of state law may be reported to legal authorities.

The general rules regarding the division of credits would apply, and the credit would not reduce regular tax below TMT.

Policy Considerations

The tax credit does not contain a sunset date. Sunset dates generally are provided to allow periodic review of credits by the Legislature.

Implementation Considerations

Department staff is working with the author's office to resolve the implementation issues identified in this analysis.

Definitions of the terms "internet service provider," "web server" and "software" and further definition of the terms "filtering software" and "tiering software" would help to ensure that disputes do not arise between taxpayers claiming the credit and the department as to who can claim the credit and the expenditures for which they can claim it.

Since this bill would allow a credit only for the purchase and installation of filtering or tiering software, no credit would be allowed to taxpayers who either create their own software or who license or lease filtering software from another company through an operating lease, which is similar to a rental agreement. However, finance leases in which a taxpayer purchases software through a lease agreement, would qualify for credit. This bill also would not allow a credit for the cost of purchasing computer hardware to run the filtering or tiering software.

While this bill would require that a taxpayer place the filtering or tiering software on its web server, it would not expressly require that providing Internet access to customers be a part of its business. Therefore, it is possible that a taxpayer could place software on a web server accessible only to its employees and still qualify for the credit.

Technical Considerations

This bill would allow a credit equal to 50% of the cost of tiering or filtering software in the year installed, with the remaining 50% allowed in the immediately succeeding year, and also would allow an eight-year carryover period. Without instructions on how carryovers from the two years should be treated, it is unclear whether the carryover period would begin after the first or the second of the two years the credit is allowed, or whether carryover from the first year would be combined with the carryover from the second year. In addition, the language limiting the carryover period is contradictory: It would allow the credit to be carried over for the eight taxable or income years succeeding the allowance of the credit, but it also provides that the credit could be carried over until exhausted, which could be longer than eight years.

FISCAL IMPACT

Departmental Costs

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are not expected to be significant.

Tax Revenue Estimate

Revenue losses under this bill would depend on the number of ISPs that purchase filtering or tiering software, the cost of that software and the ability of the ISPs to apply credits generated.

According to industry sources, filtering software for an ISP can vary significantly depending on the number of users and the type and degree of filtering offered. These cost can range from as little \$3,000 to as much as \$1 million or more. However, as a practical matter it is not anticipated that the average ISP would expend a million dollars for tiering or filtering software. It is assumed that many larger ISP's would develop much of their own customized software and thus would not qualify for credit.

Since the credit allowed by this bill would be equal to 100% of the cost to purchase or install tiering or filtering software, annual revenue losses could potentially be several million dollars per year. However, it is not possible to further estimate annual revenue losses under this proposal for the following reasons:

Since the term "Internet service provider" is not defined, it is unclear how many taxpayers would be eligible to claim this credit.

It is not known to what extent service providers would develop their own software (which would not qualify for the credit) as opposed to those that would purchase the software.

Although this bill would allow a credit for software, it would not provide a credit for the hardware needed to run filtering or tiering software.

This bill does not clearly define tiering or filtering software. As written an ISP could purchase limited filtering or tiering software requiring annual or monthly screening of new Internet sites and never update their software to screen new sites as they are created.

BOARD POSITION

Pending.